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DEFENSE
CONTRACTING

Terminating Major
Weapons Contracts for
the Government's
Convenience



144742

**National Security and
International Affairs Division**

B-244600

August 30, 1991

The Honorable James Sasser
Chairman, Committee on the Budget
United States Senate

The Honorable John Conyers, Jr.
Chairman, Committee on Government Operations
House of Representatives

The Honorable Frank McCloskey
Member, Committee on Armed Services
House of Representatives

As requested, we obtained information on the Department of Defense's (DOD) procedures for terminating contracts for the convenience of the government. Specifically, we (1) identified whether changes had occurred in DOD's termination clauses and the types of allowable costs over the last 10 years, (2) compared termination procedures among the DOD agencies,¹ (3) determined whether private industry had comparable termination procedures, (4) ascertained whether changes to DOD's termination procedures were being considered, (5) determined whether DOD had criteria for identifying the most appropriate weapon systems as candidates for termination, and (6) addressed DOD's system to forecast major weapon system termination costs.

Results in Brief

Our review showed the following:

- Federal regulations governing contract terminations for convenience, including termination clauses and allowable costs, have changed only slightly over the last decade.
- The termination procedures of DOD and each of its agencies implement and supplement federal regulations or satisfy particular needs of the specific military service and do not conflict with federal regulations.
- Termination for convenience procedures are unique to the government; private industry does not have comparable procedures.
- Changes to its termination for convenience procedures are planned by DOD and are generally intended to address administrative matters and to streamline existing regulations.

¹When we refer to DOD agencies, we are referring to the Air Force, Army, Navy, Marine Corps, and the Defense Logistics Agency (DLA).

- DOD does not have specific criteria for identifying potential candidates for termination or for determining which weapon systems, if any, should be terminated. However, DOD uses an approach in evaluating weapon system progress that helps identify systems experiencing problems.
- Modifications to DOD's existing cost reporting system could be made to provide more reliable termination cost estimates for major weapon systems.

Background

In the 1980s, DOD initiated the development of a large number of new and complex weapon systems that significantly increased the national defense budget. However, with the nation's mounting deficit crisis, serious concerns exist about whether the United States can afford to continue developing and producing large numbers of weapon systems. In addition, changes in the Soviet Union and Eastern Europe have diminished the Soviet and Warsaw Pact threat. These factors have a significant effect on the major weapon systems to be developed and produced. Recently, DOD identified major weapon systems that it intended to terminate in its fiscal year 1992-93 budget submission.²

The government can terminate contracts for convenience or for default. Termination of a contract for the convenience of the government is the right of the government to refuse to continue with contract performance—to stop the work and settle with the contractor at the point of termination. For example, the Sergeant York Division Air Defense gun system's existing contracts were terminated for the convenience of the government in August 1985 because the system could not effectively meet the growing military threat. In a default termination, the action by the government is taken because of the contractor's failure to fulfill contractual obligations. For example, the Navy's A-12 medium attack aircraft contract was terminated for default because the contractors were not making sufficient progress in meeting contractual requirements.

The Federal Acquisition Regulation (FAR) and agency regulations that implement or supplement the FAR govern contract terminations. The FAR is a single uniform regulation used by all executive agencies in their acquisition of supplies and services. Agency acquisition regulations dealing with terminating contracts are limited to (1) those necessary to implement FAR policies and procedures and (2) additional policies and

²When a weapon system involving numerous contracts is terminated, the costs of terminating all of the contracts must be totaled to determine the full cost of the termination.

procedures or contract clauses that supplement the FAR to satisfy the specific needs of the agency.

Standard Contract Termination Clauses and Types of Allowable Costs Have Not Significantly Changed

The FAR and preceding regulations that addressed contract terminations for convenience and contract clauses have remained basically the same over the last 10 years.³ For example, the language contained in termination clauses for fixed-price and cost reimbursement contracts have been standard and have remained the same over the years.

The types of allowable termination costs have also remained unchanged over the same period. The cost categories associated with a termination have included such things as (1) costs continuing after termination that cannot be immediately determined by contractors, (2) start-up costs such as initial plant rearrangement and alterations, (3) loss of useful value of special tooling, (4) rental costs under unexpired leases, (5) alterations of leased property, (6) settlement expenses (e.g., legal and clerical costs for preparation of settlement proposals and termination and settlement with subcontractors), and (7) subcontractor claims.

DOD Agencies' Procedures Implement and Supplement Existing Regulations

DOD agencies' supplemental termination procedures implement and supplement the FAR and the DOD FAR Supplement.⁴ The supplemental termination procedures vary in the level of detail among DLA and the military services. On one hand, Army guidance provides limited detail and only addresses general principles of terminations that set out responsibilities for contract terminations and the transfer of property among contractors. DLA, on the other hand, has a detailed manual that provides extensive guidance beyond that contained in the federal regulations because of the variety and volume of termination actions it handles. For example, it provides additional principles applicable to the settlement of terminated fixed-price type contracts. Regardless of the extent of detail, the DOD agencies' supplemental termination procedures do not conflict with the FAR and the DOD FAR Supplement.

³In January 1991, FAR Part 49 covering the termination of contracts was revised to increase or eliminate threshold requirements. For example, the threshold allowing prime contractors to settle with subcontractors without the prior approval of the terminating contracting officer was raised from \$25,000 to \$100,000.

⁴The DOD FAR Supplement contains material that implements the FAR as well as supplemental information that is unique to DOD. The supplement is not a stand alone document and must be used in conjunction with FAR.

In June 1990, DLA's Defense Contract Management Command was assigned responsibility for settling all DOD agencies' contracts terminated for convenience dealing with major weapon systems. Before this, the services were also responsible for settling these types of terminated contracts.

DOD and Private Industry Contract Termination Procedures Are Not Comparable

Terminations for convenience are unique to government contracting. Therefore, government and private industry procedures cannot be compared. The government retains the right to terminate contracts, in whole or in part, for its convenience, at any time during the performance of a contract to protect the public's interest. The FAR requires the government to include a termination for convenience clause in every government contract. Moreover, the courts have ruled that the government has the right to terminate a contract for convenience even when the termination clause has been omitted from the contract.⁵

In commercial contracts, terminations generally are authorized (1) as permitted by the contract, (2) by mutual consent of the parties involved—typically as a result of a negotiated settlement, or (3) when a breach of contract has occurred.

Changes to the Termination Procedures Are Planned

The DOD FAR supplement is currently being revised.⁶ Changes to the termination procedures under consideration are not generally a result of deficiencies or weaknesses in existing regulations, but are intended to address administrative matters and to streamline existing regulations. For example, one suggested change deals with whether the procurement contracting officer or the terminations contracting officer should have responsibility for de-obligating excess funds resulting from a termination.

In a related effort, a DLA adhoc working group is being established to carry out a comprehensive review of FAR provisions affecting terminations. In contrast to administrative changes, one significant area to be addressed covers the calculation of a settlement when it appears the

⁵G.L. Christian and Associates *versus* the United States, 312 F. 2d 418 (Ct. Cl. 1963).

⁶In response to an effort included in the Defense Management Review—which is a continuing effort by DOD to improve its operations—a Regulation Relief Task Force made recommendations on improving the DOD FAR Supplement. As a part of this effort, the supplement applicable to terminating contracts is being revised.

contractor would have incurred a loss had the entire contract been completed. Currently, the accepted method of calculating a settlement allows a profit for those items completed and accepted by the government, even if a loss would have been incurred had the contract been completed. Under a proposed alternative method, the cost of items completed and accepted by the government would be included in the calculation of the settlement, but not the profit associated with these items.

Once the governing regulations are revised, DLA plans to revise its manual, which prescribes policies and procedures for the settlement of contracts that have been terminated, in whole or in part, for the convenience of the government. According to a DLA official, military service procedures on terminating contracts for the convenience of the government will be considered when DLA revises its manual.

DOD Does Not Have Specific Criteria for Identifying Weapon System Terminations

As defined in DOD Directive 5000.1 dated February 23, 1991, DOD is to use an integrated approach for managing weapon system acquisitions from early development through fielding. Identifying candidate systems for termination is only an incidental by-product of this approach. Regardless of how DOD identifies potential weapon systems for termination, it is essential that it be based on realistic threats, warfighting strategies, and fiscal realities.

During our review, we focused on whether criteria were available for DOD to use in evaluating the most appropriate weapon systems to terminate. We found that DOD does not have specific criteria for evaluating which weapon systems should be terminated. Such criteria could encompass important factors that may influence the decision to terminate a weapon system program. They would include, but are not limited to (1) military requirements, (2) weapon system capabilities, (3) system performance, (4) contractor performance, and (5) the cost of procuring, operating, and supporting the program.

According to Office of the Secretary of Defense officials, identifying weapon systems to terminate is a complex process that requires a great deal of judgment. DOD's current approach is to integrate complex relationships that exist between requirements generation; acquisition management; and planning, programming, and budgeting. Even though we found that DOD's approach does not rely on specific criteria in order to identify programs for termination, DOD has identified termination candidates. Although not specifically addressed, we were advised by DOD officials that the integrated approach considered various factors when

deciding which weapon systems to terminate. For example, the TACIT RAINBOW program was recommended for termination during the fiscal year 1992 budget review because of performance problems.

In testimony before the House Armed Services Committee in July 1990,⁷ we discussed the need for a defense plan that reflects fiscal realities, and is based on current threats and warfighting strategies. DOD essentially lacked this during the 1980s and while the situation has improved somewhat, the problem still exists. As a result, DOD and the Congress annually debate canceling, delaying, or stretching out programs.

We also indicated in that testimony that the programs being planned and the level of funding that could be realistically expected were mismatched. At that time, there were over 100 major acquisition programs in various stages of development and procurement. The acquisition cost of those programs was estimated at over \$1 trillion, with well over half the amount yet to be spent. We noted that DOD needed to decide which of the planned programs it could afford. In making such decisions, we believe it is also important to know how much it would cost to terminate versus continue existing programs.

DOD's Reporting System Provides Rough Estimates of Termination Costs

DOD's existing contractor cost reporting system provides rough estimates of termination cost. However, our review indicated that modifications to the existing system could provide more reliable termination cost estimates for major weapon systems. Further, the accumulation and reporting of costs from contracts and subcontracts within a specific program to arrive at total termination costs would also help provide more reliable data to decision makers.

The Contract Funds Status Report Provides Some Information on Termination Costs

Standard contractor cost reports required for effective management are prescribed in DOD 5000.2 Manual dated February 23, 1991. The contractor cost data to be included in these reports is obtained from contractors and is to be periodically verified by the Defense Contract Audit Agency. A Contract Funds Status Report can be used, with other cost management reports, to provide DOD management with information to assist in updating and forecasting contract fund requirements. The report is normally applicable to cost type or fixed-price incentive

⁷Department of Defense: Improving Management to Meet the Challenges of the 1990s (GAO/T-NSIAD-90-57, July 25, 1990).

contracts. The report is not applicable to firm, fixed-price contracts unless unusual circumstances require specific funding visibility.⁸

The Contract Funds Status Report contains, among other things, rough estimates of costs that would be necessary to liquidate all government obligations if the contract were terminated. Although this report assumes that the contract will continue to completion, estimated termination cost by the government is reported by fiscal year and more frequently on some contracts. It can serve as a management control measure to provide reasonable assurance that termination cost estimates are adequately identified and disclosed. Those assurances are to equate to a satisfactory level of confidence given consideration of costs, benefits, and risks.⁹

Views of DOD Officials on the Existing System

DOD officials questioned the feasibility of coming up with accurate, regularly submitted, termination cost estimates because of the inherent difficulty of gathering and assessing all relevant data. For example, DOD officials told us that many variables impact the accuracy and availability of termination costs of a given DOD program such as (1) the type of program, (2) time of the termination, (3) status of work in process on other contracts at the time of termination, (4) amount and nature of inventory, and (5) the kind of facilities employed by the contractor (e.g. government or commercial). DOD officials further told us that they were also skeptical about using the Contract Funds Status Report because of the reliance on contractors' numbers. They told us that, if questioned, contractors would be tempted to either inflate the cost estimates or award contracts to significantly increase production to result in a more costly termination.

According to one DOD official, the accuracy of the Contract Funds Status Report to estimate potential termination costs is questionable for several reasons. First, the report, in practice, is used only for cost-reimbursement type contracts.¹⁰ Second, the contractor cost reporting

⁸Before the issuance of DOD 5000.2 Manual, the applicable instruction dated December 1979 stated the Contract Funds Status Report would not apply to firm, fixed-price contracts unless the contract represented the development or production of a major defense system and specific funding visibility was required.

⁹Standards For Internal Controls In The Federal Government, 1983.

¹⁰According to supplemental instructions, only those parts of the Contract Funds Status Report essential to the management of each acquisition will be required. The DOD Program Manager responsible for the weapon system will determine the need for the contract funds information and apply only those portions of the report deemed appropriate.

system used to accumulate contractor costs may not capture all costs associated with a termination such as the loss of useful life of special tooling or settlement expenses. Third, the nature of the estimated termination costs reported by the contractor can vary. For example, the DOD official explained that one contractor negotiated the level of anticipated termination costs with the government at the beginning of the contract while another contractor reported only the administrative cost for terminating the contract. Finally, the level of review performed on individual Contract Funds Status Reports has varied. As a result, the reliability of contractor's estimated termination costs has not been corroborated.

Despite these concerns, the DOD official suggested that a few changes could be made to make the Contract Funds Status Report more useful. First, the report could be required for all significant defense contracts—those over a certain dollar threshold. Second, the report could clearly define specific “estimated termination costs” so that they encompass at least most major contractor costs arising out of a complete termination for convenience and that are obtainable from the contractors cost reporting system. Finally, the report could be reviewed by a designated official responsible for maintaining the estimated termination costs reported by the contractor. However, the DOD official added that the merit of making these changes would have to be analyzed and justified by DOD before they are implemented.

Our Assessment

We acknowledge that many variables impact the accuracy and availability of termination costs for a given DOD program such as the type of program and time of the termination. However, we believe these variables are not unique to terminations but are inherently applicable to all cost estimates prepared by contractors and evaluated by DOD.

The existing Contract Funds Status Report provides some idea of the potential termination liability of terminating major weapon system contracts. However, our review indicated that more reliable termination cost estimates could be obtained if cost-effective changes are made to the existing system. We believe that DOD should (1) require the reporting of termination cost estimates on all types of major defense contracts and (2) identify the types of termination costs available from the contractors' records.

Even though some DOD officials were skeptical about relying on contractors' numbers, the Defense Contract Audit Agency is to ensure that reliable termination cost estimates are reported. According to its audit manual, the Agency is required to verify the information contained in the Contract Funds Status Report, including the contractor's estimate of potential termination costs. However, Defense Contract Audit Agency officials told us that contractor termination cost estimates have not been given a high priority. One Agency official further told us that these estimates could possibly be singled out as a special interest item to be verified for high risk weapon system programs.

Recommendation

Although the Contract Funds Status Report provides some information on potential termination costs, it should be modified to provide DOD management more accurate information for decisionmaking. To obtain more reliable contract termination cost estimates, we recommend that the Secretary of Defense identify and adopt the necessary cost-effective improvements to the existing cost reporting system. As a minimum, consideration should be given to expanding the reporting coverage and identifying the types of termination cost information available from contractors.

As you requested, we did not obtain formal agency comments. However, the views of agency officials were sought during the course of our work and are incorporated where appropriate. Appendix I contains details on our scope and methodology.

We are sending copies of this report to the Secretaries of Defense, the Navy, Army, and Air Force; the Director, DLA; and to interested congressional committees. Copies will also be made available to others on request.

Please contact me on (202) 275-8400 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with a large, sweeping initial "P" and "M".

Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

Scope and Methodology

We compared important provisions of the Federal Acquisition Regulation (FAR), such as those dealing with allowable termination costs, to the prior regulations to determine whether changes have occurred in the Department of Defense's (DOD) termination procedures and costs over the last 10 years. In addition, DOD officials were interviewed regarding their awareness of changes to the termination procedures.

The FAR was compared to the DOD FAR Supplement and individual DOD agencies' supplements to determine if they implemented or supplemented FAR. We specifically evaluated those provisions dealing with terminating contracts for the convenience of the government.

The government's right to terminate contracts for convenience was compared to procedures used for commercial contracts to determine whether they were similar. The National Security Industrial Association, which represents defense industry interests, was also contacted regarding its views on contract terminations.

We interviewed DOD officials to identify proposed changes to the existing termination regulations. We also reviewed supporting documentation for these changes.

To obtain information on DOD's approach for identifying the most appropriate weapon systems to terminate, we interviewed Office of the Secretary of Defense officials representing the Under Secretary of Defense for Acquisition, Assistant Secretary of Defense (Program Analysis and Evaluation), and DOD Comptroller. We also reviewed the applicable DOD directive, instruction, and manual dealing with DOD's approach to weapon system acquisition. While we found DOD did not have termination criteria, we did not conduct sufficient audit work on the development of such a criteria or on DOD's weapon system acquisition approach to make a recommendation at this time.

Finally, Office of the Secretary of Defense and DOD agency officials were interviewed to address the feasibility of DOD introducing a system for estimating and reporting major weapon system termination costs. In addition, we reviewed the applicable DOD instruction and supporting documents to obtain information on the cost reporting system for estimating termination costs. We did not conduct an in-depth evaluation of DOD's cost reporting system or the use of the Contract Funds Status Report to determine whether they would provide accurate estimates of termination costs.

Appendix I
Scope and Methodology

We performed our work between May 1990 and May 1991 in accordance with generally accepted government auditing standards.

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